United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

76-7278

B

United States Court of Appeals

FOR THE SECOND CIRCUIT

MARGARET MARY McDONNELL MURPHY,

Plaintiff-Appellant,

P/S

—against—

McDONNELL & Co., INCORPORATED and THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, President,

Defendants,

JAMES F. McDONNELL, JR., individually, as Trustee under the Will of James F. McDonnell and as Executor of the Estate of Anna M. McDonnell, and CHARLES E. McDONNELL, as Executor of the Estate of Anna M. McDonnell,

Plaintiff-Appellants,

—against—

THE NEW YORK STOCK EXCHANGE by ROBERT W. HAACK, THE NEW YORK STOCK EXCHANGE, INC., THE AMERICAN STOCK EXCHANGE by H. VERNON LEE, JR., Secretary, and McDONNELL & Co., INC.,

Defendants.

UNITED STATES COURT OF APPEALS
FILED
OCT 12 1976
A. DANIEL FUSARO, CLERK
SECOND CIRCUIT

BRIEF FOR PLAINTIFF-APPELLANTS MARGARET MARY McDONNELL MURPHY AND JAMES F. McDONNELL, JR. AND CHARLES E. McDONNELL, AS EXECUTORS AND TRUSTEES

DAVIS & COX
One State Street Plaza
New York, New York 10004
Attorneys for Plaintiff-Appellants

Of Counsel:

MAXWELL E. COX
WALTER H. BEEBE
MARC J. ADELSOHN

October 8, 1976.

TABLE OF CONTENTS

Table of Authorities

United States Court of Appeals

For the Second Circuit

Docket No. 76-7278

Margaret Mary McDonnell Murphy,

Plaintiff-Appellant,

—against—

McDonnell & Co., Incorporated and The New York Stock Exchange by Robert W. Haack, President,

Defendants,

James F. McDonnell, Jr., individually, as Trustee under the Will of James F. McDonnell and as Executor of the Estate of Anna M. McDonnell, and Charles E. McDonnell, as Executor of the Estate of Anna M. McDonnell,

Plaintiff-Appellants,

—against—

The New York Stock Exchange by Robert W. Haack, The New York Stock Exchange, Inc., The American Stock Exchange by H. Vernon Lee, Jr., Secretary, and McDonnell & Co., Inc.,

Defendants.

BRIEF FOR PLAINTIFF-APPELLANTS MARGARET MARY McDONNELL MURPHY AND JAMES F. McDONNELL, JR. AND CHARLES E. McDONNELL, AS EXECUTORS AND TRUSTEES

Preliminary Statement

This is an appeal from a final judgment entered after a jury trial as to three claims to enforce liabilities created

by the federal securities laws, including, *inter alia*, Section 6 of the Securities Exchange Act of 1934 (the "Act") (15 U.S.C. § 78f), Section 10(b) of the Act (15 U.S.C. § 78j(b)) and Rule 10b-5 (17 C.F.R. 240.10b-5) of the Securities and Exchange Commission (the "Commission") promulgated thereunder:

(1) The claim of Anna M. McDonnell* against McDonnell & Co., Incorporated ("McDonnell & Co."), the New York Stock Exchange (the "Exchange") and the American Stock Exchange (the "Amex") (a) that McDonnell & Co., faced with an ultimatum from the Exchange to raise additional capital, fraudulently induced her to make a subordinated loan to the firm of securities valued at approximately $1,600,000, and (b) that the failure of the Exchange and of the Amex to discharge their responsibilities under the Act caused both the procurement and the loss of this investment;

(2) The claim of Margaret Mary McDonnell Murphy, Mrs. McDonnell's daughter, against the Exchange that the failure of the Exchange to discharge its regulatory responsibilities caused the loss of $282,623 that she suffered because McDonnell & Co., pursuant to the same ultimatum, fraudulently induced her to make a subordinated loan of securities to it; and

(3) The claim, on behalf of a trust created under the will of Mrs. McDonnell's husband (the "McDonnell Trust") against the Exchange and the Amex for failure to discharge their regulatory duties by permitting McDonnell & Co. fraudulently to substitute for a debenture that was about to become due and payable a new subordinated debenture in the principal amount

* Mrs. McDonnell died subsequent to the trial and her executors have been substituted as appellants.

of $328,000, which became worthless because the Exchange and the Amex did not discharge properly their responsibilities under the Act.

The judgment of the District Court denied these claims.

Statement of the Issues

1. Did the District Court commit error in instructing the jury that the Exchange could make a specific temporary exception to the requirements of its net capital rule and could make the requirement "easier", when (a) the Exchange did not contend that a specific temporary exception had been made and there was no evidence that would permit the jury to find that an exception had been made, (b) the Act does not permit the Exchange to make the net capital requirement "easier", and (c) the effect of the charge was to make the net capital requirement a nullity?

2. Did the District Court commit error by refusing to instruct the jury that Section 6 of the Act imposed a duty of disclosure on a registered national securities exchange when (a) the member firm was operating in violation of the rules of the exchange, including its net capital rule, (b) the exchange insisted that the member firm raise additional capital, (c) the exchange knew or had reason to know that the amount of capital that it was requiring the member firm to raise would not cure the violations of its rules?

3. Did the District Court commit error in not directing a verdict, or in not granting a judgment notwithstanding the verdict, against the Exchange and the Amex, when neither exchange had enforced either the provisions of the Act or their rules, in any meaningful manner, with resulting loss to the plaintiffs?

4. Was it error for the District Court on the one hand to permit the Exchange to introduce evidence to support a defense that the Commission had general oversight over the Exchange's regulatory conduct and had approved that conduct and on the other hand to exclude rebuttal evidence of the plaintiffs that showed beyond question that the Commission had not approved and, to the contrary, was highly critical of the manner in which the Exchange had discharged its regulatory functions?

5. Was it error for the District Court to dismiss claims against one national securities exchange because it had delegated its regulatory responsibilities under the Act to another national securities exchange?

6. Was it error for the District Court to admit into evidence testimony as to family relationships and connections of the plaintiffs that were irrelevant to any issue in this case? Did the rulings of the court as to this and other evidence so prejudice the plaintiffs that a new trial is required?

Statement of the Case

Introduction

These consolidated actions have their genesis in the demise of McDonnell & Co. on March 13, 1970.

McDonnell & Co. had experienced severe and continuing operational and financial problems at least as early as the fall of 1967. By October of 1968 McDonnell & Co. had lost all control over its back-office and record-keeping. Its ratio of indebtedness to net capital was well in excess of the 2,000 per centum that both Section 8 of the Act (15 U.S.C. § 78h) and Rule 325 of the Exchange required for lawful

operations. (See the Exchange's Chronologies dated October 28, 1968 (Ex. 33a at E-15)* and March 28, 1969 (Ex. 46 at E-53) and Memo to the Board of Governors dated October 22, 1970 (Ex. 83) and testimony of Exchange officials Andrew McElroy (Vol. II-III; Tr. 591-809) and Herbert Schuette (Vol. III; Tr. 810-1020)).

The transactions that caused plaintiffs' losses took place in the midst of this crisis. McDonnell & Co. effected the substitution of the subordinated debenture in December 1968. McDonnell & Co. procured the subordinated loans that Mrs. Murphy and Mrs. McDonnell made to it at the end of January 1969, at the insistence of the Exchange and as the Exchange's response to McDonnell & Co.'s violation of the Act and of the Exchange's rules. (Testimony of Mrs. Murphy (Vol. I; Tr. 34-197 and VII; Tr. 2342-2350) and Deposition Testimony of Mrs. McDonnell (Vol. I; Tr. 198-243 and IV; Tr. 1022-1055)

McDonnell & Co. never did solve either its record-keeping or net capital problems. The investments that the plaintiffs had made in McDonnell & Co. became worthless when the firm closed its doors.

The amended complaints claimed that these losses arose from the fraudulent conduct of McDonnell & Co. and from the failure of the Exchange and the Amex** to discharge

* The trial exhibits ("Ex.") referenced in this Brief are contained in the Record on Appeal or the Exhibit Volume of the Appendix ("E-"). Both original and retyped exhibits are included in case of legibility questions, and references are to the retyped versions. The trial transcript ("Tr.") appears in Volumes I-VIII of the Appendix.

** The District Court did not permit Mrs. Murphy to amend her complaint to add the Amex as a defendant. For this reason, Mrs. Murphy has instituted a separate action against the Amex in the District Court. This action is in abeyance pending a determination of this appeal. Civil Action No. 75 Civ. 417 R.O. (S.D.N.Y.).

their regulatory responsibilities under the Act. The defendants denied all wrongdoing and claimed that since the losses were all in the McDonnell family, they had no responsibility.

The Trial

The consolidated actions were tried to a jury before Honorable Richard Owen, United States District Judge.

The plaintiffs introduced evidence to establish that (a) at the time Mrs. McDonnell and Mrs. Murphy subordinated their securities, neither knew material adverse information concerning the financial and operating condition of McDonnell & Co., (b) McDonnell & Co. fraudulently procured the substitution of the subordinated debenture owned by the McDonnell Trust without the knowledge or consent of two of the three trustees, (c) the Exchange and the Amex knew of these transactions and failed either to disclose material adverse information known to the Exchange concerning the condition of McDonnell & Co. or to require that the member firm make adequate disclosure itself, (d) the Exchange and the Amex failed to supervise and regulate properly the financial and operational affairs of McDonnell & Co., permitting it to continue in business despite its continual violation of the net capital rule and other rules of the Exchange, and (e) this failure led both to the solicitation of the subordinated investments and the eventual collapse of McDonnell & Co.

The defendants maintained that the investors knew all about the finances and operations of McDonnell & Co. and that, in any event, the investments were prompted by considerations of family loyalty so that McDonnell & Co.'s finances and operations were immaterial. The defendants interjected into the proceedings, at every opportunity, such fascinating tid-bits as that Mrs. McDonnell's father

was one of the founders of Consolidated Edison, that one of her daughters had married Henry Ford II, that Mrs. McDonnell had once ordered flowers for another daughter through McDonnell & Co., all of which had no relevance and no legitimate purpose.

The Exchange and the Amex maintained that the regulation and supervision of McDonnell & Co. had been proper and that their regulatory and supervisory responsibilities did not encompass any duty to disclose any facts concerning the financial and operating conditions of member firms to investors or to require any disclosure by the member firm. Additionally, the Amex maintained that its regulatory and supervisory responsibilities had been completely and effectively delegated to the Exchange and that this delegation discharged its responsibility under the Act.

Both the Exchange and the Amex sought to show that the Commission had blessed the manner in which they had handled McDonnell & Co. and its problems. When plaintiffs sought to introduce documentary evidence that showed precisely the opposite, the court upheld objections to this evidence. It said it would remove the issue from the case. It never did so.

The Charge to the Jury

The District Court directed a verdict in favor of the Amex on all claims and in favor of the Exchange on all claims involving allegations of fraud. (Vol. VII; Tr. 2357). The court expressly found that the Exchange had no duty of disclosure to the plaintiffs. The court submitted the claims of the plaintiffs to the jury on the theory of fraud by McDonnell & Co. in violation of Section 10(b) and Rule 10b-5 and on the theory of improper regulation by the Exchange in violation of Section 6.

The District Court instructed the jury that it had to find each of three elements in order to establish the liability of the Exchange under Section 6 of the Act:

> "One, that the exchange had reason to believe or suspect that its member was acting in violation of the rules of the exchange.
>
> "Two, that the exchange thereafter failed to take reasonable action.
>
> "And, three, that such failure to act was the proximate cause of damage to the plaintiff in question." (Vol. VIII; Tr. 2629).

In connection with the first element—reason to believe or suspect a violation of the duties of the Exchange—the court charged that the applicable portions of the Exchange's net capital rule were as follows:

> "Rule 325 establishes net capital requirements for the exchange members which at all material times in this act required that 'No member'—this is of the exchange—'No member shall permit in the ordinary course of business as a broker its aggregate indebtedness to exceed 2000 percentum of its net capital,' as that latter term is defined and computed under Rule 325; and then it goes on to, *'Unless a specific temporary exception is made by the exchange in the case of a particular member or member organization due to unusual circumstances.'*
>
> "Thus, under Rule 325 the exchange is permitted in the case of a particular member organization to prescribe stricter net capital requirements." (Vol. VIII; Tr. 2630-2631).*

---

* All emphasis in this brief has been supplied.

Counsel for the plaintiffs objected to the court's including the language of exception in its charge. He pointed out that counsel for the Exchange had specifically stated that he was *not* contending that an exception had been made in the case of McDonnell & Co. (Vol. V; Tr. 1488). Counsel for the Exchange, on the other hand, wanted the court to clarify the charge to make clear that "it can go either way. You can except or you can provide stricter requirements." (Vol. VIII; Tr. 2648-2649). Counsel for the plaintiffs reiterated his objection on the ground that the exception issue was not in the case. The court sidestepped the issue. It stated to plaintiffs' counsel:

> "The Court: Mr. Beebe, I can't resolve that at this point without seeing the transcript, and I have got the jury here and I am going to have to rely on the fact that this is a rule which exists, and either it's relevant or it isn't relevant. *It either fits or it doesn't fit. If it fits the fact the jury finds, then it does; if it doesn't, it is irrelevant.*" (Vol. VIII; Tr. 2649).

The Court then reinstructed the jury as to Rule 325, emphasizing the power to make an exception and concluding: "Thus, I want it to be clear that they could make the [requirement] tough or *easier* under the rules as they existed." (Vol. VIII; Tr. 2659). The jury then retired for its deliberation.

In connection with the second element to Section 6 liability under the court's charge—that the Exchange failed to take reasonable action—plaintiffs requested the following instructions:

> ". . . [I]f you find:
>
> "1. that an exchange knew or had reason to believe or suspect that McDonnell & Co. was in violation of the net capital rule;

"2. that the exchange thereafter directed McDonnell & Co. to raise additional capital; and

"3. that the exchange failed to take appropriate steps to disclose the net capital violation to potential investors or to ascertain whether the firm had disclosed the net capital violation to potential investors,

"Then you must find that the action taken was not appropriate." (A-142-143).

The District Court refused so to charge and failed to include in its explanation of the term "reasonable or appropriate action" any language to the effect that reasonable or appropriate action must, in certain circumstances, include disclosure. (Vol. VIII; Tr. 2629-2634).

The Verdict and Judgment

On instructions that (a) permitted the jury to find that the Exchange could always make the net capital requirement easier and (b) removed any possible duty of disclosure from the Exchange, the jury returned a verdict on the claims and theories submitted to it: in favor of Mrs. Murphy in the sum of $300,000 against McDonnell & Co.; in favor of the McDonnell Trust in the sum of $350,000 against McDonnell & Co.; in favor of McDonnell & Co. on all remaining claims against it; and in favor of the Exchange on all claims against it. The court, on the motion of McDonnell & Co., reduced the damages awarded to Mrs. Murphy to $282,623 and those awarded to the McDonnell Trust to $318,622 (A-213) and entered judgment accordingly. (A-219).

The Appeal

By this appeal, plaintiff-appellants seek judgment against the Exchange and the Amex on all claims and against Mc-

Donnell & Co. on the claims of Mrs. McDonnell. Alternatively, plaintiff-appellants seek a new trial on their claims against the Exchange and the Amex and on the claims of Mrs. McDonnell against McDonnell & Co.

Statement of Facts

McDonnell & Co. from at least the fall of 1968 continually violated the net capital rule of the Exchange and continuously violated its record-keeping rule. The Exchange, instead of taking decisive action, temporized. It required McDonnell & Co. to raise additional capital but it took no steps to see to it that those who supplied the capital were informed of the risks.

The financial and operating difficulties that ultimately resulted in the collapse of McDonnell & Co. first became apparent in the fall of 1967. They were not unique to McDonnell & Co. for many brokerage firms had similar problems during the so-called "paper crunch" of 1967 and 1968. (Ex. 86 at E-190). In the case of McDonnell & Co., however, they were fatal because of the failure of the Exchange to take any meaningful action to enforce the requirements of the Act and of its own rules.

The Exchange took a stab at ameliorating these problems in 1968, after reviewing the responses of McDonnell & Co. to the financial questionnaire that a member firm must submit annually to the Exchange. The accountants for McDonnell & Co. had begun their audit in connection with this questionnaire in October 1967. McDonnell & Co. did not submit the questionnaire to the Exchange until February 6, 1968, after four extensions and more than three months beyond the original due date. The responses revealed record-keeping problems so substantial that the Exchange imposed operating restrictions calculated to pre-

vent any increase in the size of the firm's business. (Ex. 79 at E-3).

The restrictions lasted all of three weeks. The Exchange lifted the restrictions at the request of the firm's management, who represented that McDonnell & Co. could put its own house in order. Shortly after the Exchange removed the restrictions, it permitted McDonnell & Co. to open a new brokerage office. (Ex. 81).

McDonnell & Co. never did put its house in order. The Exchange had accepted the proposed conversion to a computer data processing system as a panacea for the firm's record-keeping problems. It had done so notwithstanding its prior criticism of attempts to undertake full conversion of record-keeping to computer operations unless current, accurate and balanced records were being maintained. McDonnell & Co. never did maintain current, accurate and balanced records. (Vol. V; Tr. 1793-1825).

The Exchange received strong indications through the remainder of 1968 that all was not well with McDonnell & Co., (Exs. 19, 30, 33a at E-15, 34a at E-20, 35a at E-28, 36, 46 at E-53, 60, 71, 72 at E-5, 73, 80, 82, 83 at E-198 and 96a at E-7; testimony of Schuette, *supra*, and George Newman (Vol. IV; Tr. 1056-1185)), yet it still failed to act. Instead, it waited for the audit and annual financial questionnaire. A series of delays, like those of the year before, punctuated the 1968 audit and the preparation of the questionnaire.

While this audit was in progress, T. Murray McDonnell, President of McDonnell & Co., caused the McDonnell Trust to exchange a debenture of McDonnell & Co. maturing on December 31, 1968, for a newly-issued debenture maturing in 1982. By this transaction, McDonnell & Co. bolstered its capital in the amount of $318,622 at the expense of the McDonnell Trust. The Exchange, informed of this sub-

stitution, made no effort to ascertain whether or not the transaction was authorized. The jury found that it was not.

Delays in the preparation of the audit and of the questionnaire continued. The Exchange granted extensions of time on the representation of McDonnell & Co. through its auditors that the firm was in compliance with the net capital requirement. (Ex. DD). The representation was false.

On January 9, 1969, McDonnell & Co. advised the Exchange that the audit would show that the firm was not in compliance with the net capital requirement. (Ex. 38 at E-41). On January 13, 1969, McDonnell & Co. reported to the Exchange that as of October 31, 1968, the member firm needed $1,700,000 to bring its ratio up to the 2,000% required by Section 8 of the Act and the Exchange's Rule 325 and that, in addition, two partners were in the process of leaving the firm and withdrawing approximately $400,000 in capital. (Ex. 37 at E-42) (Schuette, Vol. III; Tr. 852-857).

The audit submitted to the Exchange on January 15, 1969 reported the violation of the net capital rule. (Ex. Z). The Exchange's January 28, 1969 analysis of McDonnell & Co.'s figures showed that the firm needed $2,869,648—not $1,700,000—to cover its minimum net capital deficit as of October 31, 1968. (Ex. 39 at E-47).

Finally, on January 29, 1969, the Exchange acted. At a meeting with McDonnell & Co. officials, the Exchange ordered the member firm to obtain $500,000 in additional capital by 3 P.M. on January 31st, an additional $2,083,000 one week thereafter, and either an additional $300,000 or a corresponding reduction of $1,000,000 in outstanding shorts within the month. (Ex. 40 at E-49) (Schuette, Vol. III; Tr. 870-872).

The Exchange neither knew nor cared where or how McDonnell & Co. would obtain the capital. The Exchange did nothing at all about adequate or, for that matter, any disclosure to potential investors, either as to the need for the money or as to the problems that required that the money be raised.

Given the requirement to come up with additional capital by the day after tomorrow, what happened was predictable. The president of McDonnell & Co. turned to his mother and sister. He did not turn to some 11 other family members whose business acumen undoubtedly would have interfered with hurried decisions. (Olney, Vol. V; Tr. 1775-1785). Mrs. McDonnell agreed to deposit securities valued at over $1,300,000 in an existing subordinated account at McDonnell & Co. Mrs. Murphy agreed to subordinate $283,000 worth of securities. Mrs. McDonnell had a general impression that conditions at the firm were worse than in prior years but neither her son nor anyone else told her of the specific material adverse facts required to make an informed decision. A telephone call sufficed. Mrs. Murphy agreed to subordinate her securities on the basis of representations that simply were not true. On the very afternoon that the Exchange issued its ultimatum, McDonnell & Co. informed the Exchange that it would have $1,500,000 new capital by the January 31st deadline and an additional $1,000,000 by February 20, 1969. (Ex. 40 at E-50).

The Exchange did not impose any restrictions on McDonnell & Co. to ameliorate the firm's record-keeping problems that gave rise to the capital violation. (Vol. II; Tr. 612 and Vol. III; Tr. 834). Instead, it again relied on McDonnell & Co.'s ability to put its own house in order while it operated under voluntary restrictions.

The subordination of Mrs. McDonnell's and Mrs. Murphy's securities did not bring McDonnell & Co. into compliance with the net capital requirement. The Exchange had not made any current calculation of McDonnell & Co.'s net capital deficiency before Mrs. McDonnell and Mrs. Murphy subordinated their securities. After the subordination, a special financial questionnaire as of January 30, 1969, showed that even with the additional capital the ratio of aggregate indebtedness to net capital was 3,825% and that after revision for questionnaire errors and adjustments the ratio came to an astronomical 5,515%. (Exs. 25 and 83 at E-211-212; see table of net capital computations, Ex. 107 for identification at E-281).

The Exchange took other steps *after* McDonnell & Co. had received over $2 million in new capital from the plaintiffs. The Exchange sent examiners to the firm who stayed from February 18, 1969 through April 8, 1969, such was the extent of the mess. They reported on April 24, 1969, that the serious capital problem "may have been continuous from October 31, 1968 . . . at least into March, 1969" and that "[d]ue to the condition of the records, any capital computation prepared at the present time is questionable without a detailed audit." (Ex. 25).

The Exchange took other steps but they were all too late. Restrictions imposed in May of 1969 included a requirement that McDonnell & Co. obtain from any new capital contributor a letter ("knowledgeability letter") indicating he had been made aware of the firm's financial position. No such letter had been required of the plaintiffs. (Ex. 56a).

Through the summer and fall of 1969, McDonnell & Co.'s operational and financial situation went from bad to worse. The situation had so far deteriorated by the end of 1969 that the 1969 audit could not even be com-

pleted. In March 1970, McDonnell & Co. closed its doors. (McDonald, Vol. V; Tr. 1818-1823).

In the fall of 1970 the Exchange formally charged McDonnell & Co. with numerous violations of the net capital, record-keeping and other rules of the Exchange. The Exchange's witnesses at the trial characterized these charges as the "final determination of violations". (Arning, Vol. V; Tr. 1359-1360, 1364-1365). "They are really the best [evidence of the facts]". (Bishop, Vol. VI; Tr. 2093). These charges are an indictment of the Exchange as well as McDonnell & Co. because they show that in the case of McDonnell & Co. the Exchange failed to enforce its rules, as well as the provisions of the Act, in any meaningful manner.

POINT I

The Failure of the Trial Court Properly to Instruct the Jury on the Duties of a National Securities Exchange Requires Reversal.

The Exchange had the duty under Section 6 of the Act and its agreement with the Commission (Ex. 77 at E-1) to comply, and to enforce so far as was within its powers, compliance by McDonnell & Co., with the provisions of the Act and the rules and regulations of the Commission thereunder, including:

(a) the net capital requirements of Section 8(b) of the Act and of the Exchange's Rule 325, both of which made it unlawful for McDonnell & Co. to engage in business when its ratio of indebtedness to net capital exceeded 2,000 per centum, as well as other rules of the Exchange for the protection of those who dealt with a member firm; and

(b) the anti-fraud provisions of Section 10(b) of the Act and Rule 10b-5 of the Commission.

The failure of the Exchange and the Amex to discharge their regulatory responsibilities gave rise to a cause of action for the resulting losses that plaintiffs suffered.* Because neither exchange took any meaningful steps to enforce compliance by McDonnell & Co. with provisions of the Act, with Rule 10b-5 and with their rules, plaintiffs lost in total more than a million dollars.

The jury concluded otherwise. But it did so under instructions and rulings that emasculated the regulatory duties of a national securities exchange. Under the court's instructions:

(a) The Exchange instead of enforcing its net capital requirement could make it "easier" at will;

---

* *Baird* v. *Franklin*, 141 F.2d 238 (2d Cir.), *cert. denied*, 323 U.S. 737 (1944); *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, [1975-76 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,513 (9th Cir. 1976), *affirming* [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,133 (C.D. Cal. 1973), *petition for cert. filed*, 45 U.S.L.W. —— (U.S., August 19, 1976), Docket 76-248; *Rich* v. *New York Stock Exchange*, 522 F.2d 153 (2d Cir. 1975); *Butterman* v. *Walston & Co.*, 387 F.2d 822 (7th Cir. 1967), *cert. denied*, 391 U.S. 913 (1968); *Phillips* v. *American Stock Exchange*, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,035 (S.D.N.Y. 1975); *New York Stock Exchange, Inc.* v. *Sloan*, [1974-1975 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,037 (S.D.N.Y. 1975); *Marbury Management, Inc.* v. *Kohn*, 373 F.Supp. 140 (S.D.N.Y. 1974); *Steinberg* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,599 (S.D.N.Y. 1974); *Hochfelder* v. *Midwest Stock Exchange*, 350 F.Supp. 1122 (N.D. Ill. 1972), *aff'd*, 503 F.2d 364 (7th Cir.), *cert. denied*, 43 U.S.L.W. 3202 (U.S. Oct. 15, 1974); *Weinberger* v. *New York Stock Exchange*, 335 F.Supp. 139 (S.D.N.Y. 1971); *Bright* v. *Philadelphia-Baltimore-Washington Stock Exchange*, 327 F.Supp. 495 (E.D. Pa. 1971); *Pettit* v. *American Stock Exchange*, 217 F.Supp. 21 (S.D.N.Y. 1963).

(b) The Exchange had no duty to make disclosure of relevant facts to plaintiffs or to take any steps to see that its member firm did so;

and under the court's rulings

(c) The Amex discharged its duties by delegating them to another national exchange.

Each of these instructions and rulings was erroneous.

1. The Exchange Could Not Reduce The Net Capital Requirement At Will; The Exchange Never Claimed That It Had Done So

The net capital rule "from the beginning has been the primary protection against financial irresponsibility of brokers." * The court below submitted this case to the jury on an instruction that in practical effect made Rule 325 meaningless because the Exchange could always make an exception and could ease the requirements in a particular case as it saw fit.

The instruction should never have been given:

(a) as a matter of law the Exchange could not impose easier requirements; and

(b) the Exchange never claimed and indeed bitterly resisted the suggestion that it had made any exception in the case of McDonnell & Co.

a. The Charge Erroneously Stated The Law

Section 8(b) of the Act makes it unlawful for any member of a national securities exchange:

"To permit in the ordinary course of business as a broker his aggregate indebtedness to all other persons

---

* *Study of Unsafe and Unsound Practices,* p. 10, [Transfer Binder—Special Studies] CCH Fed. Sec. L. Rep. ¶ 74,801 (1971).

. . . to exceed such percentage of the net capital (exclusive of fixed assets and value of exchange membership) employed in the business, but *not exceeding in any case 2,000 per centum,* as the Commission may by rules or regulations prescribe as necessary or approriate in the public interest for the protection of investors."

The Commission, pursuant to Section 15(c)(3)* of the Act adopted Rule 15c-3,** which imposed a maximum 20:1 ratio of "aggregate indebtedness" to "net capital" upon all brokers and dealers subject to the rule. But the Commission excluded from the operation of the Rule members of seven stock exchanges, including the Exchange and the Amex, upon a finding that their "rules, settled practices and applicable regulatory procedures [were] deemed by the Commission to impose requirements *more comprehensive* than the requirements" of the Commission's rule.***

The Exchange's Rule 325,**** as in effect at all relevant times, contained the same 2,000 per centum limitation as the Act.

---

* 15 U.S.C. § 78n(c)(3).

** 17 C.F.R. 240.15c-3.

*** SEC Securities Act Release No. 3617 (Nov. 8, 1944). Counsel for the Exchange stated on the record that the court could take "judicial notice" of the fact that Rule 15c-3 "exempts from its application members of the national securities exchanges which have a more comprehensive capital rule". (Vol. III; Tr. 808).

**** Rule 325 provided, in relevant part:

"(a) No member or member organization doing any business with others than members or member organizations or doing a general business with the public, except a member or member organization subject to supervision by State or Federal banking authorities, shall permit, in the ordinary course of business as a broker, his or its Aggregate Indebtedness to exceed 2000 per centum of his or its Net Capital, which Net Capital shall be not less than $50,000 in the case of a member organization carrying any accounts for customers and shall be not less

Until at least 1963 the Exchange "viewed its net capital rule as being of fundamental importance in assuring the financial responsibility of member organizations." * According to the Special Study of the Securities Market that the Commission made for Congress in that year, "the net capital rule . . . is regarded by the Exchange as the most important rule administered by the department of member firms.** And, indeed, the Special Study lauded the Exchange for its strict enforcement of its net capital rule:

> "The enforcement by the Exchange of its net capital rule should be the standard by which other aspects of its regulatory program are judged. The staff vigorously seeks out violations and they are processed swiftly and fairly." ***

Nothing less than vigorous enforcement would protect those who dealt with member firms:

> "*Violation of the rule has always been regarded as* meaning that there is *an immediate threat* to customers of the broker-dealer and to others with whom he deals

---

(Cont'd.)

than $25,000 in the case of any other member or member organization subject to this rule, unless a specific temporary exception is made by the Exchange in the case of a particular member or member organization due to unusual circumstances.

" . . .

"The Exchange may at any time or from time to time in the case of a particular member or member organization prescribe *greater* requirements than those prescribed herein.

"Each member or member organization shall promptly notify the Exchange if his or its Net Capital does not equal or exceed the minimum required by this rule."

* *Case Study of the Interpretation and Enforcement of the Net Capital Rule of the New York Stock Exchange*, 220 (1972) (Ex. 102 for id. at E-230).

** *SEC, Report of Special Study of Securities Markets,* H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 4 at 526 (1963).

*** *Idem* 527.

which must be immediately rectified. The threats posed by continued violation of the net capital rule can be analogized to the prospective danger of bank insolvency." *

For this reason the Exchange could summarily suspend a member firm even without a hearing if the firm was in violation of the net capital rule. *J. R. Williston & Beane, Inc.* v. *Haack*, 387 F. Supp. 173 (S.D.N.Y. 1974). As the *amicus* memorandum of the Commission in that case stated:

> ". . . a broker-dealer who is *not in compliance* with net capital requirements *must be prevented*, as promptly as possible, *from conducting any further business, and placing any more investors in financial jeopardy,* until its net capital deficiency has been remedied." (*Id.* at 180).

The Exchange's enforcement of the net capital rule was anything but vigorous as to McDonnell & Co. Instead of preventing its member firm from conducting any further business and placing any more investors in financial jeopardy, the Exchange permitted McDonnell & Co. to operate for at least a year and a half in more or less continuous violation of the rule. (Exs. 46 at E-53, 83 at E-198, and 107 for identification at E-281).

The plaintiffs claimed that the failure to enforce the net capital rule, coupled with the failure to enforce other rules such as the record-keeping rule, was what caused the loss to them as investors. The importance of the net capital rule to plaintiffs' case is shown by the fact that *after* the subordination of the accounts of Mrs. McDonnell and Mrs. Murphy, McDonnell & Co., according to the Exchange, had

---

* *Hearings Before the Subcomm. on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 92d Cong. 2d Sess., Securities Industry Study,* pt. 4 at 324 (1972).

a net capital deficiency of at least $2 million and a ratio of indebtedness to net capital of 2,918%. (Exs. 23b, 25; Ex. 107 for identification at E-281).

The District Court recognized the importance of Rule 325 to this case. But its instructions to the jury robbed the rule of any meaning by changing it from "one of the important protections for the investing public", whose "enforcement . . . should never depend on whether actual loss has in fact already occurred",* to a license to the Exchange to do pretty much what it pleased.

Under the court's charge the jury could find that the explanation for the failure of the Exchange to enforce effectively its net capital rule might well be that it had eased the requirement, for if that was not what the charge permitted, then the charge was meaningless.

The charge was in error. The court overlooked that the Act itself specifically provides that *in no case* shall the aggregate indebtedness of a member firm exceed net capital by more than 2,000 per centum.

This congressional mandate overrides any rules of the Exchange. If the Exchange's rule permitted it to decide that in a particular case the ratio might exceed 2,000 per centum, then the rule is a nullity. But nothing in Rule 325 suggests that the Exchange could make some higher ratio than 2,000 per centum permissible in a particular case.**

---

* *Securities and Exchange Commission* v. *General Securities Co.*, 216 F.Supp. 350, 351 (S.D.N.Y. 1963). *See also Blaise D'Antoni & Associates, Inc.* v. *Securities and Exchange Commission*, 289 F.2d 276, 277, *rehearing denied*, 290 F.2d 688 (5th Cir. 1961).

** When Rule 325 is read in its entirety against the statute, it becomes apparent that the exception proviso is applicable only to the requirements that the net capital shall not be less than $50,000 in the case of a member organization carrying any accounts for customers and not less than $25,000 in the case of any other member or member organization subject to the rule.

Rule 325 specifically provides that the Exchange "may at any time or from time to time, in the case of a particular member or member organization, prescribe *greater* requirements than those prescribed herein." It does not say that the Exchange may at any time or from time to time prescribe *lesser* requirements than those prescribed therein. It could not do so consistent with the Act and with the Exchange's statutory responsibility under Section 6 of the Act.

b. *The Charge Should Never Have Been Given, Let Alone Repeated*

By emphasizing that the Exchange could make an exception, by reemphasizing the point and then making it clear—erroneously—that the Exchange could make the net capital requirement easier as well as tougher, the court handed to the Exchange a defense that it had not urged and that was not permissible under the evidence.

Judge Owen instructed the jury in this case to consider *all* the court's instructions. (Vol. VIII; Tr. 2599). Since a jury naturally assumes that the court's instructions are intended to have serious import and that a charge fits the specific facts of the case instead of being an abstract statement of legal principles which may or may not have something to do with its deliberations, a trial court must confine its instructions to the jury to the issues raised by the evidence.*

As the Sixth Circuit stated in *Jackson* v. *Crockarell*, 475 F.2d 746, 748 (6th Cir. 1973):

---

* *E.g., Jackson* v. *Crockarell*, 475 F.2d 746 (6th Cir. 1973); *Smith* v. *Mill Creek Court, Inc.*, 457 F.2d 589 (10th Cir. 1972); *Lyle* v. *Bentley*, 406 F.2d 325 (5th Cir. 1969); *Peterson* v. *Mountain States Tel. & Tel. Co.*, 349 F.2d 934 (9th Cir. 1965); *Brown* v. *Chapman*, 304 F.2d 149 (9th Cir. 1962).

"It is reversible error for the court to give instructions which leave the way open for a jury to consider a question that has been suggested or mentioned during the trial which is not at issue or is not supported by the evidence."

Here, nothing in the evidence suggested that the Exchange had made "a specific temporary exception" in the case of McDonnell & Co. Lee Arning, the senior Exchange witness, testified that the Exchange had not suspended the rules for the Company. (Vol. IV; Tr. 1384, *1386-1387*, 1395-1396, 1398, *1414*) and that he did not know of any departure from the rules for McDonnell & Co. (Vol. IV; Tr. *1422*, 1426-1428). Robert Bishop so testified twice. (Vol. VI; Tr. 2059 and Vol. VII; Tr. 2268-2269). The Exchange's charging memorandum set forth violations of the net capital rule. It could not have done so had the Exchange made an exception as to McDonnell & Co. (Ex. 83 at E-211-212). *Cf.* McElroy (Vol. III; Tr. 705), Schuette (Vol. III; Tr. 859, 974-975), Judge Owen (Vol. VI; Tr. 935), Bishop (Vol. VII; Tr. 2168).* Indeed, counsel for the Exchange specifically stated that he was *not* contending that an exception had been made. (Vol. V; Tr. 1488).

When counsel for plaintiffs excepted to the charge, and when counsel for the Exchange urged the court to repeat the charge to make clear that "[i]t can go either way", (Vol. VIII; Tr. 2648) the court below abdicated its responsibility because the jury was waiting.

In the court's view, if the portion of the rule about a specific temporary exception did not fit the facts that the jury ultimately found, then that portion of the charge

---

* Mr. Bishop testified that the requirements of Rule 325 could be made "more stringent." (Vol. VI; Tr. 1900). There was no evidence that they could be made more lenient.

would be irrelevant. The trial court overlooked that its responsibility was to instruct the jury as to the law applicable to the facts, not as to irrelevancies.

The court's repeating the instructions compounded the error, particularly with the addition, as virtually the last words to the jury, that the Exchange could make the requirements easier. (Vol. VIII; Tr. 2647-2650).

The court thus effectively removed from the case any issue as to whether the Exchange had denied to the plaintiffs the protection that Section 8(b) of the Act and Rule 325 were intended to afford those who dealt with a member firm, with the result that the investments of plaintiffs in that firm were not only in jeopardy when made but ultimately lost when the Exchange, after prodding from the press and Congress (McDonald, Vol. VI; Tr. 1818-1823), finally did enforce its rules and shut down the member firm.

On the basis of the established facts, the jury below should and would have found under appropriate instructions of law that the Exchange had violated the provisions of the federal securities laws and that such violations had proximately resulted in damage to the plaintiffs.

2. The Exchange Had A Duty Of Disclosure

The Exchange, with a callous disregard for the protection of investors, insisted that it had no duty of disclosure whatsoever, notwithstanding the net capital violation, notwithstanding the record-keeping mess, notwithstanding that the Exchange was the one requiring its member firm to raise new capital within two days. The District Court agreed.

But disclosure lies at the heart of the Act and the Exchange had a duty to comply and to enforce compliance by its member firms with the Act.

The Supreme Court stated in *Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963): "A fundamental purpose common to the statute was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and to achieve a high standard of business ethics in the securities industry."

The decision of the court to withdraw from the jury the disclosure issue is directly contrary to the holding in *Fischer* v. *The New York Stock Exchange* [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,416 (S.D. N.Y. 1976). There Judge Lasker found that, depending upon the facts, an exchange may be under an affirmative duty to disclose material facts concerning the condition of a member firm, when the exchange actively participates in soliciting subordinated loans to that member firm. In denying defendant's motion to dismiss a complaint based in part on the exchange's failure to inform prospective lenders that its member firm had been placed on restrictions and was experiencing serious financial problems, the District Court concluded:

> ". . . the Exchange cannot gainsay a duty to disclose facts material to the lenders decision to extend their subordinated loan contracts when it directly participated in the solicitation of the extension.
>
> * * *
>
> "We conclude that the sounder view is that a duty to disclose may arise in some circumstances, including perhaps, those pleaded in the complaint, solely on the basis of a failure to act. The motion to dismiss on this ground is therefore denied. Summary judgment is also denied because *the existence of such a duty is a question of fact* which cannot be answered at this stage of the proceedings." (*Id.* at p. 99,103).

Here the District Court withdrew from the jury the *question of fact* as to whether the circumstances of this case required disclosure.

The decision in *Fischer* was made within the context of liability pursuant to Section 10(b) of the Act and Rule 10b-5 promulgated thereunder. *Cf. Hughes* v. *Dempsey-Tegeler & Co., Inc.,* [1975-1976 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,513 (9th Cir. 1976), *affirming* [1973 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,133 (C.D. Cal. 1973), *petition for cert. filed,* 45 U.S.L.W. —— (U.S., August 19, 1976), Docket 76-248. Here, too, Section 10(b) of the Act imposed an affirmative duty of disclosure because the Exchange, knowing of the material adverse facts, including the violation of the net capital rule, actively participated in soliciting the new investment. See *Affiliated Ute Citizens* v. *United States,* 406 U.S. 128, *rehearing denied,* 407 U.S. 916 (1972); *Superintendent of Insurance* v. *Bankers Life & Casualty Co.,* 404 U.S. 6 (1971). Unlike the accountants in *Ernst & Ernst* v. *Hochfelder,* —— U.S. ——, 96 S. Ct. 1375 (1976), the Exchange in this case had extensive knowledge of the material adverse facts and actively participated in the solicitation process so that it could be charged with the requisite scienter. *Herzfeld* v. *Laventhol, Krekstein, Horwath & Horwath,* [Current] CCH Fed. Sec. L. Rep. ¶ 95,660 (2d Cir. 1976).

The reasoning of *Fischer* is even more persuasive in the context of an alleged violation of Section 6: first, because it is pursuant to Section 6 that a stock exchange undertakes to comply with the provisions of the Act, including the disclosure provisions; and second, because an exchange in directing a member firm to raise additional capital acts pursuant to its regulatory and supervisory power under Section 6.

It is anomalous indeed to conclude, as did the District Court here, that a member firm may violate the federal securities laws by soliciting investments without making full disclosure, but that a securities exchange charged with the obligation of enforcing compliance with those laws by the member firm has no duty to supervise, or make disclosure when it directs that member firm to solicit additional capital, purportedly in the discharge of its regulatory function.

If ever there was a case in which a reasonable regulatory response required full disclosure, it is this one. The Exchange could have taken the requisite steps to suspend McDonnell & Co. until it had cured its net capital deficiency, if possible, with full disclosure to those who supplied the capital. The Exchange did not do so. Instead, it issued its ultimatum, and so long as McDonnell & Co. raised $500,000 within two days and other amounts thereafter, McDonnell & Co., despite the fact that the violation of the 2,000% limit would not be corrected, despite the record-keeping mess, could continue in business without any restrictions on its operations except ones that it voluntarily imposed upon itself. Instead, it sent its member firm out into the world to raise hundreds of thousands of dollars of capital within two days.

Full disclosure could not conceivably be made within two days. Yet that very afternoon the word came back to the Exchange that McDonnell & Co. had raised an additional million and a half in capital. The Exchange's statutory duty required that it assure itself so far as within its powers that those supplying the capital had an appreciation of the risks, including the risk that the Exchange would shut down McDonnell & Co. for violating its rules. Moreover, central to the required disclosure was the Exchange's own role in the regulation of McDonnell & Co.

Was it going to stop temporizing while the violations of its rules continued? Would the additional capital in the the Exchange's view bring McDonnell & Co. into compliance with the net capital requirement? If the Exchange did not know the answer to these questions, then it had no business issuing its ultimatum in the first place.

The refusal of the court below to permit the jury to consider the Exchange's failure to make disclosure, or to require its member firm to make disclosure, in determining whether the Exchange had taken reasonable action to remedy a violation by the member firm, left the jury to assess the Exchange's Section 6 liability against an improper and incomplete standard. In view of the Exchange's admitted non-disclosure, a reversal of the decision below and a directed verdict in favor of Mrs. Murphy and Mrs. McDonnell is required. See Point II, *infra*. At the very least, the error in the charge requires a new trial on the claims of these investors as against the Exchange.

3. The District Court Should Not Have Directed a Verdict in Favor of the Amex

The Amex took the position that its liability pursuant to Section 6 was limited to damages resulting from a failure to enforce its own rules. The Amex argued that since its rules provided that the Exchange should perform the regulatory and supervisory functions as to dual Exchange-Amex member firms, the Amex had not failed to enforce its rules. The District Court's directed verdict is apparently based on this reasoning.

The provisions of Section 6 of the Act and the liability of an exchange thereunder are not limited, however, to failures to enforce exchange rules. Rather, Section 6 requires that an exchange agree ". . . to comply, and to enforce so far as is within its powers compliance by its

members, with the provisions of [the Act] and any amendment thereto and any rule or regulation made or to be made thereunder." The provisions of Section 6 define an exchange's enforcement responsibilities in terms of exchange members; the statute does not comprehend a waiver or a delegation of those responsibilities simply because a particular brokerage firm happens to be a member of more than one exchange.

Moreover, even if the Amex's liability under Section 6 were limited to the enforcement of its own rules and the Amex had properly delegated its enforcement role to the Exchange, the direction of the verdict in favor of the Amex was still improper. One cannot avoid liability for improper discharge of a statutory duty by delegating that duty to another. Thus, the case should have been submitted to the jury against both exchanges with an appropriate instruction that if the jury found the Amex had delegated its duty to the Exchange and the Exchange had thereafter failed to properly discharge that duty, then both exchanges were jointly and severally liable for any resulting damages. But in light of the Amex's complete abdication of its statutory responsibilities, a directed verdict on the claims against it would have been more appropriate.

POINT II

The Trial Court Should Have Directed a Verdict, or Entered Judgment Notwithstanding the Verdict Against the Exchange and the Amex.

The court submitted this case to the jury under erroneous instructions. Properly instructed, the jury could not have failed, consistent with the evidence, to return a verdict against the Exchange and the Amex. The failure of the Exchange and the Amex to discharge their regulatory duties was so complete that the court should have granted either plaintiffs' motion for a directed verdict or their motion for judgment notwithstanding the verdict.

Even if the Exchange had some discretion as to whether it would permit McDonnell & Co. to continue in business, notwithstanding its violation of the net capital requirement, notwithstanding the state of its records, there comes a point at which the response of the Exchange to those violations exceeds as a matter of law the bounds of reasonableness.

The Ninth Circuit defined the applicable principles in *Hughes* v. *Dempsey-Tegeler & Co., Inc., supra.* There the plaintiff contended that the Exchange had failed properly to regulate and supervise the operations of Dempsey-Tegeler and that, as a proximate result, he had lost the value of the securities he had placed in a subordinated account to supply Dempsey-Tegeler with capital with which to meet the net capital requirement. The District Court recognized that while the Exchange's regulatory role must, in view of the complex nature of the industry, involve some degree of discretion, such discretion is not unlimited:

> ". . . the 'discretionary' charge foresees *mandatory* action under certain conditions. Accordingly, it cannot be deemed that the exchange has been given unrestrained discretionary authority to regulate member firms—rather its charge was *to comply in all respects* with the provisions of [the Act] in relation to its control over member firms." *Supra,* [1973 Transfer Binder] at p. 94,539.

The District Court then proceeded to apply a good faith test to the manner in which the Exchange had exercised its discretion and concluded that this discretion had not been abused. The court, in concluding that the Exchange had acted in good faith, stressed that the Exchange had in good faith decided not to suspend Dempsey-Tegeler but to try and solve the firm's problems by an infusion of new capital and that that decision and the Exchange's doubts about the firm's potential recovery were fully disclosed to the proposed subordinated lender.

The Ninth Circuit disagreed with the District Court's good faith standard:

> "Standing alone, the fact that the Exchange acted in good faith is not a sufficient defense against an action brought under Section 6." *Supra,* [1975-1976 Transfer Binder] at p. 99,612.

The correct standard was one of reasonableness.

The Ninth Circuit found in *Dempsey-Tegeler* that the Exchange had violated its duties under Section 6 because, as a matter of law, the Exchange had not acted reasonably in removing restrictions on Dempsey-Tegeler at the time the plaintiff had subordinated his securities. Nevertheless, the Ninth Circuit affirmed the judgment for the Exchange, solely because the plaintiff had not only been in-

formed as to the lifting of the restrictions but had conditioned his agreement to subordinate his securities on the lifting of the restrictions. As to the unreasonableness of the Exchange's conduct, the court stated, in language equally applicable to the Exchange's conduct in this case:

> "... Without the restrictions, the *only response* by the Exchange to the very serious problems of Dempsey *was the addition of new capital. This failure of the Exchange to take constructive action toward the underlying problems* of Dempsey *constitutes a clear breach of its duty.* If the Exchange determined that the lower level restrictions had not succeeded, it was obligated to suspend the firm. Instead, its attempted resolution so ignored the Exchange's duty owed to investors and potential investors in Dempsey that it far exceeds any permissible degree of discretion or flexibility in choosing a response. . . ." *Supra*, [1975-1976 Transfer Binder] at p. 99,618.

Here, too, the only response of the Exchange to the very serious problem of McDonnell & Co. was the addition of new capital. Here, unlike in *Dempsey-Tegeler*, the Exchange made no effort to inform the potential investors of anything, let alone the risks involved. Here, as in *Dempsey-Tegeler*, the attempted resolution so ignored the Exchange's duty owed to investors and potential investors that it far exceeded any permissible degree of discretion or flexibility, as a matter of law. Under these circumstances a directed verdict was required.

POINT III

The Errors of the Court in Admitting and Excluding Evidence Require a New Trial.

In the course of the trial, the court made a series of evidentiary rulings, each serious enough in itself to require a new trial. Cumulatively, these errors resulted in a one-sided and prejudicial proceeding that deprived plaintiffs of any semblance of a fair trial.

1. The Court Refused to Admit Evidence to Rebut the Exchange's Previously Admitted Evidence That the Commission Had Approved of Its Conduct

During the trial, the Exchange took the position that its supervisory and regulatory role was subordinate to that of the Commission, and that the SEC had supervised the Exchange's discharge of its regulatory functions with respect to McDonnell & Co. Over plaintiffs' repeated objections, the court permitted the Exchange to elicit testimony concerning the Commission's supervisory role in the securities industry and to introduce into evidence correspondence between the Exchange and the Commission concerning the Commission's oversight of the Exchange's regulatory activities. Exs. 000 at E-99, SSS at E-159, and TTT at E-160) (Vol. VI; Tr. 2022-2024, 2042-2048). The evidence introduced by the Exchange invited the jury to draw the inference that the Commission was aware of the Exchange's regulatory conduct and had approved of that conduct. (Vol. IV; Tr. 1157-1158, 1170-1176, Vol. V; Tr. 1503-1504, Vol. VI; Tr. 1865-1868, 1872-1873, 1880-1881, 1887-1889, 1892-1894, 1897, 2041-2043, 2045-2048, 2055).

In order to rebut this inference, plaintiffs repeatedly sought to introduce evidence that the Commission had in

fact been highly critical of the Exchange's regulatory conduct. The trial court consistently refused to receive this evidence. (Vol. IV; Tr. 1325, Vol. VI; Tr. 2173-2180, Vol. VII; Tr. 2190-2191, 2263). But the Exchange had raised the inference of approval and the jury was entitled to know what the Commission, in fact, thought of the Exchange's discharge of its duty of self-regulation.

Among the documents that the court refused to admit in evidence, for example, was a letter dated April 29, 1970, from the Director of the Commission's Division of Trading and Markets to the President of the Exchange in which the Director expressed grave doubts about whether the Commission would continue the Exchange's exemption from provisions of the Commission's own net capital rule. The letter stated that the Exchange had engaged in improper practices in applying its net capital Rule 325:

> "The administration by the exchange of the rule has been characterized by relaxations of previous applications and interpretations or adjustments made to bring firms into purported compliance. This implementation of the rule defeats this purpose of assuring financial liquidity and undermines the fundamental objective of the rule which is to protect investors, member firms, and others who do business with such firms." (Ex. 104 for identification at E-100).

A similar document which the court excluded is the letter of November 25, 1970 from the Chairman of the Commission to the President of the Exchange, in which the Commission Chairman emphasized that a member firm should not continue to do business when in violation of the net capital rule:

> "[The Commission found] that the very circumstance of non-compliance by a member organization

> of the exchange with its net capital requirements compels the finding that such organization is in such financial condition that it cannot be permitted uninterruptedly to continue to carry on business as usual with safety to its customers and other creditors." (Ex. 105 for identification at E-227).

Clearly, both these letters were relevant to rebut the inference, from evidence which the court permitted the Exchange to introduce, that the Commission had approved of the Exchange's discharge of its regulatory function.

A belated and ineffectual attempt of the court to eliminate the issue of Commission oversight from the case (Vol. VII; Tr. 2330-2337, 2351-2357) did not correct the prejudicial effect of this one-sided evidence. While the court stated that it would withdraw the issue from the case, and barred the defendants from arguing the issue in their closing statements, it did not instruct the jury to disregard prior evidence or argument concerning so-called Commission approval. And the court, perhaps unwittingly, itself raised the issue that it had promised to remove from the case, when it charged: "The exchange has adopted a constitution and rules which were approved by the SEC. The exchange and its rules are subject to surveillance by the SEC. . . ." (Vol. VIII; Tr. 2627). The court left the jury to resolve that issue solely on the basis of the totally misleading record that the court's rulings had created.

2. The Trial Court Improperly Excluded Evidence That Would Have Shown the Unreasonableness of the Exchange's Regulatory Response.

Under the court's instruction, plaintiffs bore the burden of demonstrating that the Exchange had acted in an unreasonable fashion and had abused its discretion in the

discharge of its regulatory function with regard to its member firm. In an effort to establish some standard of reasonable regulation by which the jury could assess the Exchange's conduct, plaintiffs attempted to introduce evidence and elicit testimony concerning the manner in which the Exchange had dealt with similar violations by other firms. The trial court, over objection, permitted the Exchange to elicit extensive comparison testimony about the Exchange's "normal" experiences with other firms, and conclusions and opinions of its witnesses, not based on facts, as to what a good job of regulation the Exchange had done. (Vol. III; Tr. 974, 977, Vol. IV; Tr. 1201-1203, 1208, 1238-1239, Vol. VI; Tr. 1901, 1905, 1967-1973, 1999-2003, 2008-2009, 2012-2013, Vol. VII; Tr. 2306-2310).

Yet the trial court, to shorten the trial, then refused to permit the introduction of the plaintiffs' evidence on this issue:

> The court refused to permit the investors to examine Mr. Bishop, who had been Director of the Exchange's Department of Member Firms and its Chief Regulatory Officer, concerning the manner in which the Exchange reacted to difficulties experienced by the firms of Picard & Co. and Dempsey-Tegeler & Co. (Vol. VII; Tr. 2225-2238);*
>
> The court blocked questioning about the Exchange's regulation—or failure to regulate—during the 1968-1969 period (Vol. VI; Tr. 2165-2166, 2173-2174, Vol. VII; Tr. 2250, 2254-2256);
>
> The court severely restricted the examination of Lee Arning, a Vice President of the Exchange, concerning

---

*** In contrast the court permitted testimony concerning other firms to be elicited on direct examination by the Exchange. (Vol. VI; Tr. 2012-2014).**

the general discharge of the Exchange's regulatory function and refused to receive in evidence a magazine interview with Arning concerning the Exchange's enforcement of the net capital rule (Vol. IV; Tr. 1372-1384; Ex. 85 for identification at E-189); and

The court refused to permit plaintiffs to elicit testimony concerning the relative seriousness of the problems at McDonnell & Co. (Vol. III; Tr. 687-818, 829-830), while permitting Mr. Bishop to testify in response to questions by the Exchange as to the relative effectiveness of corrective measures instituted by the member firm (Vol. VI; Tr. 1976-1979).

The desire to shorten a trial does not warrant the court's depriving the plaintiffs of a fair trial on the one claim against the Exchange that was presented to the jury for decision.

3. The Court Improperly Admitted Evidence as to the Wealth and Social Position of the Defendants

Throughout the trial the court, over objection of the defendants, admitted into evidence a great deal of irrelevant information about Mrs. McDonnell and her family. Much of this evidence and comment of counsel was more appropriate to the society pages or to a gossip column than to a court of law. All of it was calculated to lead the jury to conclude that the lawsuit was nothing more than a squabble among rich relatives. (Vol. VII; Tr. 2428). For example:

Counsel for McDonnell & Co., in his opening statement, informed the jury that Mrs. McDonnell was the daughter of one of the co-founders of Consolidated Edison and that one of her daughters had married Henry Ford (Vol. I; Tr. 14, 16). Neither of these facts

had one thing to do with the case. Mrs. McDonnell did not lose over a million and a half dollars by investing in either Consolidated Edison or the Ford Motor Company.

The court permitted defendants to elicit testimony, over objection, that Mrs. McDonnell had used her brokerage account at the member firm to pay for flowers for one of her daughters and, in general, had used her account at McDonnell & Co. in the same manner an ordinary person might use a checking account. (Vol. IV; Tr. 1046-1048).

Richard Olney III, a former employee of McDonnell & Co. testified, over objection, that he had dealt extensively with the various brokerage accounts maintained at the firm by various members of the McDonnell family who were not parties to the lawsuit. In addition, Mr. Olney, over objection, testified concerning estate and gift planning undertaken by the member firm for Mrs. McDonnell. (Vol. V; Tr. 1744-1746). Once again the testimony may have established an inference of wealth but had little, if any, relevance to the issues.

At every conceivable opportunity the defendants slipped the name Henry Ford into the record. (*E.g.*, Vol. II; Tr. 326, Vol. V; Tr. 1491; Vol. VII; Tr. 2461). A typical example occurred during the course of Mr. Olney's testimony about a 1969 meeting to discuss the future of McDonnell & Co., Mr. Olney listed as among those present Anne Johnson. Over objection, the court permitted counsel for the Exchange to ask: "Could you tell us who Anne Johnson was?" Mr. Olney was well-prepared. He did not reply that Anne Johnson was one of Mrs. McDonnell's daughters. Instead, predictably, he replied: "She had been married to Henry Ford." (Vol. V; Tr. 1764-1765). Judging from the

number of times it was mentioned, the relationship between the McDonnells and Henry Ford II was about as important to the case as the net capital requirement.

See also Vol. I; Tr. 22-24; 116-117, Vol. II; Tr. 323-326, Vol. IV; Tr. 1210-1211, Vol. VI; Tr. 1909-1910.

A trial in the courts of the United States is supposed to be a reasoned search for the truth of the issues properly before the court. When unduly prejudicial evidence, even if remotely relevant, reaches the jury, it seriously jeopardizes and may completely undermine this fundamental principle of impartial and dispassionate justice. Where, as in this case, the evidence was both irrelevant and prejudicial, a new trial is required. See *Transit Casualty Co.* v. *Transamerica Insurance Co.*, 387 F.2d 1011, 1013 (8th Cir. 1967). See also *Beck* v. *Wings Field Inc.*, 122 F.2d 114, 117 (3d Cir. 1941).

CONCLUSION

For the reasons stated, the judgment of the District Court should be reversed as to the claims of Mrs. Murphy, Mrs. McDonnell and the McDonnell Trust against the Exchange and the Amex and as to the claim of Mrs. McDonnell against McDonnell & Co. with direction to enter judgment in favor of the plaintiff, or, in the alternative, for a new trial.

Respectfully submitted,

Davis & Cox
One State Street Plaza
New York, N. Y. 10004
Attorneys for Plaintiff-Appellants

Of Counsel:

Maxwell E. Cox
Walter H. Beebe
Marc J. Adelsohn

Dated: October 8, 1976.

COPY RECEIVED

OCT 8, 1976

LORD, DAY & LORD
ATTORNEYS FOR AMERICAN STOCK EXCHANGE

PRG&M 10/8/76
Pearl Meier

COPY RECEIVED

OCT 8 1976

MILBANK, TWEED, HADLEY & McCLOY
ATTORNEYS FOR New York Stock Exchange